1. ... 2. Held sale installment
64-SBE-098

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
WESTERN ASPHALT & REFINING CO,)

Appearances:

For Appellant: Robert M. Himrod, Attorney at Law

For Respondent: A. Ben Jacobson, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Western Asphalt & Refining Co. against a proposed assessment of additional franchise tax in the amount of $2,574.39 for the income year ended February 28, 1955.

Appellant was incorporated in California on January 10, 1946. It adopted a fiscal year ending on February 28 and employed the accrual method of accounting. Its directors, officers, and stockholders were Donald M. Prentice (450 shares), H. G. Phillipps (450 shares), and Leland B.. Prentide (100 shares).. Appellant's principal, activity was the refining and sale of asphalt and petroleum products. Its refinery, located in the City of Santa Maria, County of Santa Barbara, was acquired in 1946 at a cost of $98,443.91 for depreciable assets and $3,550.00 for the land. Purchased out of the estate in bankruptcy of its former owner, the property was old and run-down but appellant made no substantial improvements to it. Appellant's net profits over the next eight years averaged $8,171 per annum. By November 1, 1954, the'adjusted cost basis of the property had been reduced to $44,050.27.

'Appeal of Western Asphalt & Refining Co,

On November 1, 1954, appellant entered into a written agreement with Douglas Oil Company of California (hereinafter referred to as "Douglas")., This agreement stated that appellant leased the refinery, including all land, buildings, improvements, fixtures and personalty located on or used in connection therewith, to Douglas for a period of ten years. Douglas agreed to pay a rental of $3,333.33 per month for the first year, $2,916.67 per month for the second and third years, $1,000.00 per month for the fourth year, and $500.00 per month during the remaining fifth through tenth years. Douglas had the option of purchasing the leased property for the sum of $35,000. This option could be exercised only during the fifteen days immediately preceding the expiration of the third year.

Appellant agreed to assign all of its existing contracts for the sale of asphalt and petroleum products to Douglas. If any of the contracts were not assignable, appellant agreed to purchase the products to be delivered thereunder from Douglas. It was agreed that during the first year H. G. Phillipps would devote so much of his time as Douglas might require to service the assigned contracts and to seek new orders from existing customers. Appellant also had certain tank car leases which it agreed to assign to Douglas. During the ten-year term of the agreement appellant and its officers promised not to carry on the business of refining within the County of Santa Barbara and they agreed that for a period of three years they would not sell asphalt, road oils or asphaltic products within certain specified counties of the States of California, Arizona, New Mexico, Nevada, Oregon, Utah and Washington, in which appellant had been doing business.

In accordance with the rent schedule, Douglas paid appellant $110,000 during the first three years. On October 17, 1957, Douglas elected to exercise its option to purchase the leased property for the sum of $35,000. Meanwhile the appellant had commenced dissolution and its interest in the refinery had been transferred to its stockholders.

Douglas continued to operate the refinery for only a short time. On October 15, 1958, approximately one year after it exercised its option to purchase, Douglas sold the plant for $23,500 to Donald M. Prentice and his wife, Elizabeth A. Prentice, as joint tenants, 'While appellant states that the refinery was in substantially the same, condition as, it was when Douglas exercised its option, it is admitted that some of the equipment had been removed. There is no evidence, however, as to the value of' the removed items., Mr, Prentice purchased the property as an investment and not for the purpose of continuing the asphalt business.

The Franchise Tax Board determined that the agreement between appellant and Douglas was in substance a sale rather than a lease. It contends that the entire gain on the sale, $100,949.73, must be included in appellant's income for the year of sale, the income year ended February 28; 1955.

It is well settled that calling a transaction a "lease" does not make it' such, if in fact itis something else. The determination of whether an agreement is a lease or a contract of sale depends upon what the-parties intended it to be. (Oesterreich v. Commissioner, 226 F.2d 798, 801.) To discern the true character of the transaction, therefore, it is necessary to ascertain this intention as evidenced by the written agreement, read in light of the attending facts and circumstances existing at the time the agreement was executed. (D. M. Haggard, 24 T.C. 1124, 1129, aff'd, 241 F.2d 288.) In ascertaining this intent, it appears that each case must be decided in light of its particular facts for there is no single test or general rule applicable to all cases. (Rev, Rul. 55-540, 1955-2 Cum. Bull. 39.)

We are not concerned here'with what the parties called the transaction'nor with what they may mistakenly believe,.,,' to be its name. Labels are not controlling. The criterion is what the parties believed to be the legal effect of the transaction. If two parties enter into an-agreement which they honestly believe to be a lease but which'in actuality has all the elements of a contract of sale, it is a sale and not a lease no matter what the parties call it. We must, therefore, look to the intent of the parties in terms of what they intended to happen.. (Oesterreich v. Commissioner,. supra, 226 F.2d 798, 801, 802.)

Under the agreement in question, Douglas was to take possession of the refinery and obtain all of appellant's exist;' ing contracts for the sale of asphalt and petroleum products, the services of one of appellant's officers in carrying on the business, and ..covenants not to compete, Appellant states that the major portion of the payments to be made in the first three years was concerned with the acquisition of the going business rather than the physical facilities and that, for all substantial purposes, appellant's business, customers and goodwill *were* "assimilated by Douglas during this period. It seems clear that such was the result intended by the parties when they entered the agreement. Upon the payment of $110,000, Douglas was given two choices. 'It could retain possession of the physical assets for the full term of-the agreement, paying a total of $48,000, *or it* could immediately take title to the assets, which, apparently had a certain salvage value, *for a* cash settlement of $35,000.

Analyzed in this fashion, we conclude that the record before us establishes a reasonable inference that the parties intended a sale at'the time they entered their arrangement. Douglas's prime purpose was the acquisition of appellant's business. This it accomplished, In addition, it was obligated, under either alternative, to pay the full value of appellant's plant and equipment.' It was merely a question of whether Douglas would exercise its.option to take title so that it could get the benefit of whatever salvage value the refinery might have. The advantages of this latter course are obvious and we believe that the pasties had them in mind when 'they reached their agreement. Furthermore, the events following the exercise by Douglas of its option raise real doubts as to whether Douglas ever seriously contemplated using the facilities for a full ten-year term. There is even a question of whether, in view of its age and, condition, the refinery had a useful life of ten years. These factors create a heavy burden of persuasion which appellant has failed to carry.'

Appellant's sole argument on this point is that the agreement should be construed, to be a lease because the option price was substantial in relation to the value of the assets purchased. The size of the option price is of little. significance, however, where the buyer is obligated,. in any case, to pay an equivalent amount. Appellant *relies* upon the case of Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319, involving *an* agreement under which the lessee of certain plant facilities was required to pay rent of $20,000 per year for a term of five years, renewable for three additional years, The lessee had an option to purchase for $50,000 at the 'end of the fifth and sixth years, $37,500 at the end of the seventh year, and $25,000 at the end of the eighth year. In holding that the agreement was a lease and'not a contract for sale, the court distinguished several contrary cases on the ground that they involved situations where "the rent paid was substantially, equal to the value of the goods and the buyer was bound to pay this amount." (Breece Veneer & Panel Co. v. Commissioner, supra, 232 F.2d 319, 322,) The above distinction is closely analogous to the instant appeal and for that reason appellant's reliance is misplaced.

As an alternative position, appellant contends that if its agreement with Douglas is held to be a contract of sale, then it should be permitted to report the gain on the installment basis. Respondent's only argument in opposition is that the election to report in this manner must be made in a timely return for the year of the sale. In view of several recent federal decisions interpreting provisions similar to the install-, ment reporting provisions found in the Revenue and Taxation Code (Rev. & Tax. Code, §§ 24667 and 24668, formerly §§ 25291 and 25292), appellant's position in this connection is correct. (John F. Bayley, 35 T.C. 288; Jack Farber, 36 T.C. 1142, aff'd, 312 F.2d 729, cert. denied, 374 U.S. 828 [10 L. Ed. 2d 1051]; Baca v. Commissioner, 326 F.2d 189; F. E. McGillick Co., 42 T.C. No. 83 (1964).) In each of the above cases, the government suffered no prejudice as a result of the delay in the election to use the installment basis. In appellant's case; some of the years subsequent to that now under review are no longer 'open to adjustment, We are informed, however, that the state's interests are protected by an assessment made pursuant to section 24672 of the Revenue and Taxation Code, which requires that previously unreported. installment income be included in the measure of tax for the last pear in which a corporation is subject, to tax.

Since the parties have agreed that no additional tax would be due for the income year on appeal if the'gain were reported on the installment basis, the action of the Franchise Tax Board in denying appellant's protest against the proposed assessment for that year must be reversed,

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor, Appeal of Western Asphalt & Refining Co.

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Western Asphalt & Refining Co., against a proposed assessment of additional franchise tax in the amount of $2,574.39 for the income year ended February 28, 1955, be and the same is hereby reversed.

Done at Sacramento, California, this 18th day of December, 1964, by the State Board of Equalization.

Paul R. Leake, Chairman

John W. Lynch, Member

______, Member

Geo. R. Reilly, Member

______, Member

ATTEST: ______, Secretary